

CITY OF BALTIMORE

WASTE WATER UTILITY FUND

FINANCIAL STATEMENTS

FOR THE FISCAL YEARS ENDED

JUNE 30, 2003 AND 2002

(WITH REPORT OF INDEPENDENT AUDITORS THEREON)

CITY OF BALTIMORE
WASTE WATER UTILITY FUND
FINANCIAL STATEMENTS
FISCAL YEARS ENDED JUNE 30, 2003 AND 2002

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CITY OF BALTIMORE

MARTIN O'MALLEY

Mayor

DEPARTMENT OF AUDITS

Room 321, City Hall

Baltimore, Maryland 21202



621 E. Pratt Street

Baltimore, Maryland 21202

Report of Independent Auditors

December 9, 2003

The Mayor, City Council, Comptroller and
Board of Estimates of the City of Baltimore, Maryland

We have jointly audited the accompanying basic financial statements of the Waste Water Utility Fund of the City of Baltimore, Maryland, as of and for the years ended June 30, 2003 and 2002, as listed in the table of contents. These financial statements are the responsibility of the City of Baltimore, Maryland's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in Note 1, the financial statements present only the Waste Water Utility Fund and do not purport to, and do not present fairly the financial position of the City of Baltimore, Maryland, as of June 30, 2003 and 2002 and the changes in its financial position and its cash flows in conformity with accounting principles generally accepted in the United States.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Waste Water Utility Fund of the City of Baltimore, Maryland, as of June 30, 2003 and 2002, and the changes in its financial position and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States.

Yovonda D. Brooks
City Auditor
Department of Audits

Ernst & Young LLP

CITY OF BALTIMORE
Waste Water Utility Fund
Statements of Net Assets
June 30, 2003 and June 30, 2002
(Expressed in Thousands)

Assets	2003	2002
Current assets:		
Cash and cash equivalents.....	\$ 33,847	\$ 28,021
Accounts receivable, net:		
Service billings.....	37,080	37,296
Due from other governments.....	-	2,104
Inventories.....	110	76
Current restricted assets:		
Cash and cash equivalents.....	56,158	49,095
Investments.....	4,829	4,954
Accounts receivable, net.....	8,816	15,960
Due from other funds.....	4,344	4,607
Total current assets.....	<u>145,184</u>	<u>142,113</u>
Noncurrent assets:		
Capital assets, net.....	966,176	921,671
Bond issuance costs.....	2,526	3,455
Total noncurrent assets.....	<u>968,702</u>	<u>925,126</u>
Total assets.....	<u>1,113,886</u>	<u>1,067,239</u>
Liabilities		
Current liabilities:		
Accounts payable and accrued liabilities.....	8,550	6,153
Accrued interest payable.....	3,566	2,474
Due to other funds.....	8,042	3,189
Due to other governments.....	220	-
Compensated absences.....	3,821	3,670
Revenue bonds payable.....	4,660	2,234
General long-term debt payable.....	216	113
Accounts payable from restricted assets.....	9,388	7,861
Total current liabilities.....	<u>38,463</u>	<u>25,694</u>
Noncurrent liabilities:		
Revenue bonds payable, net.....	253,951	231,443
Compensated absences.....	2,098	1,964
General long-term debt payable.....	2,487	2,686
Total noncurrent liabilities.....	<u>258,536</u>	<u>236,093</u>
Total liabilities.....	<u>296,999</u>	<u>261,787</u>
Net Assets:		
Invested in capital assets, net of debt.....	704,863	685,195
Restricted for:		
Debt service.....	23,490	19,077
Future capital expenditures.....	50,657	55,539
Unrestricted.....	37,877	45,641
Total net assets.....	<u>\$ 816,887</u>	<u>\$ 805,452</u>

See notes to financial statements.

CITY OF BALTIMORE
Waste Water Utility Fund
Statements of Revenues, Expenses and Changes in Fund Net Assets
For the Years Ended June 30, 2003 and June 30, 2002
(Expressed in Thousands)

	<u>2003</u>	<u>2002</u>
Operating revenues:		
Charges for services (net of bad debts of \$1,920 for fiscal year 2003 and \$3,172 for fiscal year 2002)	\$ 119,211	\$ 125,509
Operating expenses:		
Salaries and wages.....	30,873	29,746
Other personnel costs.....	11,270	10,977
Contractual services.....	46,784	46,035
Materials and supplies.....	7,497	7,149
Minor equipment.....	1,864	1,607
General government overhead.....	5,766	5,638
Depreciation.....	17,213	16,685
Total operating expenses.....	<u>121,267</u>	<u>117,837</u>
Operating income (loss)	<u>(2,056)</u>	<u>7,672</u>
Nonoperating expenses:		
Loss on sale of investments.....	(309)	(1,051)
Interest expense.....	(3,260)	(1,340)
Loss on interest rate swap buyout	(6,087)	-
Total nonoperating expense.....	<u>(9,656)</u>	<u>(2,391)</u>
Income (loss) before contributions.....	(11,712)	5,281
Capital contributions.....	23,147	22,860
Changes in net assets.....	11,435	28,141
Total net assets - beginning.....	805,452	777,311
Total net assets - ending.....	<u>\$ 816,887</u>	<u>\$ 805,452</u>

See notes to financial statements.

CITY OF BALTIMORE
Waste Water Utility Fund
Statements of Cash Flows
For the Years Ended June 30, 2003 and June 30, 2002
(Expressed in Thousands)

	2003	2002
Cash flows from operating activities:		
Receipts from customers.....	\$ 114,281	\$ 105,661
Receipts from interfund services provided.....	7,470	6,920
Payments to employees.....	(41,657)	(43,196)
Payments to suppliers.....	(51,353)	(59,223)
Payments for interfund services used.....	(913)	(5,638)
Net cash provided by operating activities.....	<u>27,828</u>	<u>4,524</u>
Cash flows from capital and related financing activities:		
Payment to escrow agent for early extinguishment of debt.....	-	(95,825)
Proceeds from revenue bonds.....	27,623	141,700
Principal paid on bonds.....	(113)	(122)
Principal paid on revenue bonds.....	(2,233)	(2,155)
Payments to buyout interest rate swaps	(6,087)	-
Interest paid.....	(12,732)	(11,870)
Acquisition and construction of capital assets.....	(53,213)	(47,089)
Capital contributions.....	23,147	22,860
Changes in restricted assets.....	7,533	31,022
Net cash provided (used) by capital and related financing activities.....	<u>(16,075)</u>	<u>38,521</u>
Cash flows from investing activities:		
Interest on investments.....	1,136	3,584
Net cash provided by investing activities.....	<u>1,136</u>	<u>3,584</u>
Net increase in cash and cash equivalents.....	<u>12,889</u>	<u>46,629</u>
Cash and cash equivalents, beginning of year.....	<u>77,116</u>	<u>30,487</u>
Cash and cash equivalents, end of year.....	<u><u>\$ 90,005</u></u>	<u><u>\$ 77,116</u></u>
Reconciliation of operating income to net cash provided by operating activities:		
Operating income (loss)	<u>\$ (2,056)</u>	<u>\$ 7,672</u>
Adjustments to reconcile operating income to net cash provided by operating activities:		
Depreciation expense.....	17,213	16,685
Amortization of early extinguishment of debt.....	-	(2,072)
Loss on early extinguishment of debt.....	-	(1,053)
Changes in assets and liabilities:		
Accounts receivable.....	216	(10,823)
Due from other governments.....	2,104	(2,105)
Inventories.....	(34)	26
Accounts payable and accrued liabilities.....	2,397	1,309
Other liabilities.....	295	700
Accrued interest payable.....	1,092	(2,060)
Restricted accounts payable.....	1,527	447
Due to other governments.....	4,854	(1,013)
Due to other funds.....	220	(3,189)
Total adjustments.....	<u>29,884</u>	<u>(3,148)</u>
Net cash provided by operating activities.....	<u><u>\$ 27,828</u></u>	<u><u>\$ 4,524</u></u>
See notes to financial statements.		

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

1. Description of the Utility

The Waste Water Utility Fund (the Utility) is a separate utility within the Bureau of Water and Waste Water, which is one of the four bureaus in the City of Baltimore, Maryland's Department of Public Works. In November 1978, the voters approved a Charter Amendment establishing the Utility as a separate enterprise and required it to be financially self-sustaining and operated without profit or loss to the other funds or programs of Baltimore City (the City).

These financial statements are only of the Utility and are not intended to present the financial position, changes in financial position and cash flows of the City.

2. Summary of Significant Accounting Policies

The accounting and financial reporting policies of the Utility conform to accounting principles generally accepted in the United States (GAAP) and reporting standards as promulgated by the Governmental Accounting Standards Board (GASB) for enterprise funds.

The Utility follows FASB Statements and Interpretations issued on or before November 30, 1989, Accounting Principles Board Opinions, and Accounting Research Bulletins, unless those pronouncements conflict with GASB pronouncements.

Basis of Accounting

The financial statements have been prepared on the accrual basis of accounting whereby revenues are recorded at the time they are earned and expenses are recorded when incurred, regardless of when the related cash flows take place. Operating revenues are those that result from the services provided by the Utility; all other revenue is considered non-operating.

Cash and Cash Equivalents

Cash and cash equivalents include amounts in demand deposits, as well as short-term investments with a maturity date within three months of the date acquired by the Utility.

Investments

Investments are reported at fair value. Investments with maturities of less than one year from purchase date are reported at cost, which approximates fair value. Securities traded on national exchanges are valued at the last reported sales price.

Inventories

Inventories are stated at cost, using the moving average cost method.

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

Unbilled Waste Water Utility User Charges

Unbilled waste water user charges are estimated and accrued at year end.

Restricted Assets

Restricted Assets consist of resources that are legally obligated for the acquisition and improvement of capital facilities and revenue bond repayment requirements.

Use of Restricted Assets

When an expense is incurred for which restricted and unrestricted resources are available to pay the expense, it is the Utility's policy to apply the expense first to restricted resources, then to unrestricted resources.

Capital Assets

Purchased or constructed capital assets are reported at historical cost. Capitalization thresholds are \$250,000 for buildings, improvements, and infrastructure; and \$5,000 for equipment.

Depreciation is computed using the straight-line method over the estimated useful lives, as follows:

Buildings.....	50 years
Improvements...	20-50 years
Equipment.....	2-25 years
Mobile Equipment	5-10 years

Amortization

Bond issuance costs are amortized over the life of the issue using the straight-line method, the effect of which is not materially different than under the effective interest method. Gains and losses on the early extinguishment of debt are amortized over the shorter of the life of the new or old debt.

Sick, Vacation and Personal Leave

Employees earn one day of sick leave for each completed month of service; there is no limitation on the number of sick leave days that may be accumulated. A portion of unused sick leave earned annually during each twelve month base period may be converted to cash for a maximum of three days, computed on an attendance formula. Upon retirement with pension benefits, or termination of employment after completion of twenty or more years of service without pension benefits, employees receive one day's pay for every four sick leave days accumulated and unused as of the date of separation;

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

under any other conditions of separation, unused sick leave is forfeited. At June 30, 2003, it is estimated that accumulated non-vested sick leave for the Utility approximated \$5,839,000. Sick leave benefit expenses are recorded as a percent of conversion value based on years of service, with a maximum of 100% for employees with twenty years or more of service.

Employees can accumulate a maximum of 224 vacation and personal leave days depending upon length of service, which may be taken either through time off or carried until paid upon termination or retirement. Accumulated vacation and personal leave expenses are recorded when leave is earned.

The total vacation, personal leave and conversion value of unused sick leave recorded as a liability at June 30, 2003 and 2002 is \$5,919,000 and \$5,634,000, respectively.

3. Deposits and Investments

The Utility participates in the City's pooled cash account. At June 30, 2003 and 2002, the Utility's share of the City's pooled cash account, including both restricted and unrestricted cash, was \$26,751,000 and \$20,804,000, respectively. All of the City's pooled cash deposits are either insured through the Federal Depository Insurance Corporation (FDIC) or collateralized by securities held in the name of the City by the City's agent. At June 30, 2003, the Utility also had cash of \$800,000 on deposit with a counterparty, which was collateralized with securities held by the counterparty in the name of the Utility.

In accordance with State law, the City is authorized to invest in direct or indirect obligations of the U.S. Government, certificates of deposit, and repurchase agreements and related mutual funds. City policy requires that securities underlying repurchase agreements must have a market value of at least 100% of the cost of the repurchase agreement and the City takes possession of the securities when the repurchase agreement's maturity is over five days. Management believes the City has complied with this policy throughout the year.

Investments at June 30, 2003 and 2002 are summarized below. Investments represented by specific identifiable investment securities are classified as to credit risk by the three categories below:

- Category 1 - Insured or registered, or securities held by the City or its agent in the City's name.
- Category 2 - Uninsured and unregistered, with securities held by the counterparty's trust department or agent in the City's name.
- Category 3 - Uninsured and unregistered, with securities held by the counterparty or by its trust department or agent but not in the City's name.

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

	<u>(Expressed in Thousands)</u>	
	<u>Category 1</u>	<u>Carrying Value</u>
<u>June 30, 2003:</u>		
Repurchase agreements.....	\$3,737	\$ 3,737
U.S. Treasury and Agencies.....	<u>1,119</u>	<u>1,119</u>
	<u>\$4,856</u>	4,856
Mutual funds (uncategorized)		<u>62,427</u>
		67,283
Less: cash equivalents.....		<u>62,454</u>
Total.....		<u>\$ 4,829</u>
	<u>Category 1</u>	<u>Carrying Value</u>
<u>June 30, 2002:</u>		
Repurchase agreements.....	\$3,737	\$ 3,737
U.S. Treasury and Agencies.....	<u>27</u>	<u>27</u>
	<u>\$3,764</u>	3,764
Mutual funds (uncategorized)		<u>57,502</u>
		61,266
Less: cash equivalents.....		<u>56,312</u>
Total.....		<u>\$ 4,954</u>

4. Allowance for Doubtful Accounts

Accounts receivable are shown net of a \$3,314,000 allowance for 2003 and a \$2,427,000 allowance for 2002.

5. Interfund Balances and Activity

Balances due to/from other funds at June 30, 2003 (amounts expressed in thousands):

<u>Fund</u>	<u>Interfund</u>	
	<u>Receivable</u>	<u>Payable</u>
General	\$ 8,042	
Nonmajor proprietary funds		\$ 4,344
Waste Water	<u>4,344</u>	<u>8,042</u>
Totals	<u>\$ 12,386</u>	<u>\$ 12,386</u>

The interfund balances are primarily the result of the City's policy not to reflect cash deficits in individual funds. Also, at June 30, 2003, certain transactions between funds relating to capital financing had not been completed.

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

6. Capital Assets

Capital assets activity for the fiscal years ended June 30, 2003 and 2002 were as follows (expressed in thousands):

	Balance June 30, 2002	Additions	Deductions	Balance June 30, 2003
Capital assets not being depreciated:				
Land	\$ 2,721	\$ 33		\$ 2,754
Construction in progress	374,372	61,547	\$ 14,711	421,208
Total capital assets not being depreciated	<u>377,093</u>	<u>61,580</u>	<u>14,711</u>	<u>423,962</u>
Capital assets being depreciated:				
Buildings and improvements	750,274	13,324	33	763,565
Equipment	80,895	1,558		82,453
Total assets being depreciated	<u>831,169</u>	<u>14,882</u>	<u>33</u>	<u>846,018</u>
Less Accumulated Depreciation for:				
Buildings and improvements	(233,214)	(14,390)		(247,604)
Equipment	(53,377)	(2,823)		(56,200)
Total accumulated depreciation	<u>(286,591)</u>	<u>(17,213)</u>	<u>-</u>	<u>(303,804)</u>
Total assets being depreciated, net	<u>544,578</u>	<u>(2,331)</u>	<u>33</u>	<u>542,214</u>
Total capital assets net	<u>\$ 921,671</u>	<u>\$ 59,249</u>	<u>\$ 14,744</u>	<u>\$ 966,176</u>

	Balance June 30, 2001	Additions	Deductions	Balance June 30, 2002
Capital assets not being depreciated:				
Land	\$ 2,345	\$ 376		\$ 2,721
Construction in progress	567,317	83,311	\$ 276,256	374,372
Total capital assets not being depreciated	<u>569,662</u>	<u>83,687</u>	<u>276,256</u>	<u>377,093</u>
Capital assets being depreciated:				
Buildings and improvements	504,937	245,337		750,274
Equipment	79,501	2,203	809	80,895
Total assets being depreciated	<u>584,438</u>	<u>247,540</u>	<u>809</u>	<u>831,169</u>
Less Accumulated Depreciation for:				
Buildings and improvements	(219,134)	(14,080)		(233,214)
Equipment	(50,772)	(2,605)		(53,377)
Total accumulated depreciation	<u>(269,906)</u>	<u>(16,685)</u>	<u>-</u>	<u>(286,591)</u>
Total assets being depreciated, net	<u>314,532</u>	<u>230,855</u>	<u>809</u>	<u>544,578</u>
Total capital assets net	<u>\$ 884,194</u>	<u>\$ 314,542</u>	<u>\$ 277,065</u>	<u>\$ 921,671</u>

Interest is capitalized on assets acquired with tax-exempt debt. The amount of interest to be capitalized is calculated by offsetting interest expense incurred from the date of the borrowing until completion of the project, with interest earned on invested proceeds over the same period. During fiscal years 2003 and 2002, interest expense of \$8,505,000 and \$7,072,000, respectively (net of interest income of \$989,000 and \$1,451,000, respectively) was capitalized.

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

At June 30 2003, the Utility had outstanding commitments for construction of \$62,433,000.

7. Long-term Obligations

The Constitution of Maryland requires a three-step procedure for the creation of debt by the City of Baltimore:

- Act of the General Assembly of Maryland or resolution of the majority of Baltimore City delegates
- Ordinance of the Mayor and City Council of Baltimore
- Ratification by the voters of the City of Baltimore

Changes in long-term obligations for the year ended June 30, 2003 and June 30, 2002 are as follows (expressed in thousands):

	Balance June 30, 2002	Additions	Reductions	Balance June 30, 2003	Amounts Due Within One Year
General long-term debt payable	\$ 2,152	\$ 17	\$ 63	\$ 2,106	\$ 162
Long-term financing with State of Md.	<u>647</u>		<u>50</u>	<u>597</u>	<u>54</u>
Total general long-term debt	<u>2,799</u>	<u>17</u>	<u>113</u>	<u>2,703</u>	<u>216</u>
Revenue Bonds	236,498	26,860	2,234	261,124	
Less: unamortized charges	<u>2,821</u>		<u>308</u>	<u>2,513</u>	
Total revenue bonds payable	<u>233,677</u>	<u>26,860</u>	<u>1,926</u>	<u>258,611</u>	<u>4,660</u>
Compensated absences	<u>5,634</u>	<u>285</u>		<u>5,919</u>	<u>3,821</u>

	Balance June 30, 2001	Additions	Reductions	Balance June 30, 2002	Amounts Due Within One Year
General long-term debt payable	\$ 2,227	\$ 17	\$ 92	\$ 2,152	\$ 63
Long-term financing with State of Md.	<u>694</u>		<u>47</u>	<u>647</u>	<u>50</u>
Total general long-term debt	<u>2,921</u>	<u>17</u>	<u>139</u>	<u>2,799</u>	<u>113</u>
Revenue Bonds	192,303	142,175	97,980	236,498	
Less: unamortized charges	<u>749</u>	<u>2,322</u>	<u>250</u>	<u>2,821</u>	
Total revenue bonds payable	<u>191,554</u>	<u>139,853</u>	<u>97,730</u>	<u>233,677</u>	<u>2,234</u>
Compensated absences	<u>4,934</u>	<u>700</u>		<u>5,634</u>	<u>3,670</u>

(a) These general obligation bonds bear interest at rates ranging from 4.70% to 7.50% and mature serially through 2012.

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

(b) Under the provisions of Chapter 445, Laws of Maryland, 1968, and Chapter 286, Laws of Maryland, 1974, loans were made available to assist in the construction of sewer facilities to counties and municipalities charged with providing sewerage facilities. These loans bear interest ranging from 6.10% to 8.19% and will be due thereon in future years.

The following is a schedule of the principal and interest payments (amounts expressed in thousands) required as of June 30, 2003 to service the above debt payable by the Utility until maturity:

	General Obligation Bonds		Long-Term Financing with State of Maryland	
	<u>Principal</u>	<u>Interest</u>	<u>Principal</u>	<u>Interest</u>
2004.....	\$ 162	\$ 49	\$ 53	\$ 38
2005.....	263	33	57	35
2006.....	327	12	60	31
2007.....	201	178	64	27
2008.....	239	124	69	23
2009 to 2013.....	896	566	294	48
2014 to 2018.....	16			
2019 to 2023	2			
Total.....	<u>\$2,106</u>	<u>\$ 962</u>	<u>\$597</u>	<u>\$202</u>

The City has issued revenue bonds, the proceeds of which were used to provide funds for capital improvements of the Utility. Assets with a carrying value of \$23,490,000 at June 30, 2003, and certain revenues of the Utility are pledged as collateral for the bonds and notes. Bonds and notes outstanding (amounts expressed in thousands) as of June 30 consist of:

	<u>2003</u>	<u>2002</u>
Serial bonds series 1993-A maturing in annual installments from \$970,000 to \$1,250,000 from July 1, 2003 through July 1, 2008, with interest ranging from 5.00% to 5.50%, payable semiannually.....	\$ 6,600	\$ 6,600
Serial bonds series 1994-A maturing in annual installments from \$445,000 to \$590,000 from July 1, 2003 through July 1, 2009, with interest ranging from 4.50% to 5.00%, payable semiannually.....	3,595	3,595
Serial bonds series 1994-B maturing in annual installments from \$317,498 to \$406,000 from August 1, 2003 through February 1, 2015, with interest rate at 2.25%, payable semi-annually.....	4,319	4,629

CITY OF BALTIMORE
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Notes to the Financial Statements

	<u>2003</u>	<u>2002</u>
Serial bonds series 1994-C maturing in annual installments from \$295,000 to \$387,000 from August 1, 2003 through February 1, 2015, with interest rate at 2.50%, payable semi-annually.....	4,070	4,358
Serial bonds series 1994-D maturing in annual installments from \$200,287 to \$297,000 from August 1, 2003 through February 1, 2015, with interest rate at 3.60%, payable semi-annually	2,941	3,135
Serial bonds series 1996-B maturing in annual installments from \$138,631 to \$208,000 from August 1, 2003 through February 1, 2017, with interest rate at 3.18%, payable semiannually.....	2,398	2,532
Serial bonds series 1998-A maturing in annual installments from \$271,114 to \$414,460 from August 1, 2003 through February 1, 2019, with interest rate at 2.87%, payable semiannually.....	5,409	5,673
Serial bonds series 1999-A maturing in annual installments from \$115,609 to \$167,000 from August 1, 2003 through February 1, 2019, with interest rate at 2.52%, payable semiannually.....	2,243	2,356
Serial bonds series 1999-B maturing in annual installments from \$420,851 to \$652,000 from August 1, 2003 through February 1, 2021, with interest rate at 2.61%, payable semiannually.....	9,515	9,925
Serial bonds series 2001-A maturing in annual installments from \$545,000 to \$819,000 from August 1, 2003 through February 1, 2022, with interest rate at 2.3%, payable semiannually.....	12,774	12,774
Serial bonds series 2002-A maturing in annual installments from \$1,145,000 to \$1,660,000 from July 1, 2009 through July 1, 2021, with interest rate at Muni-CPA to 5.0%, payable semiannually.....	18,925	18,925
Serial bonds series 2003-A maturing in annual installments from \$1,930,000 to \$2,095,000 from July 1, 2023 through July 1, 2025, with interest ranging from 4.125% to 4.20% payable semiannually	6,035	-
Term bonds series 1990-B, with interest at 3.806% payable semiannually, due February 1, 2012.....	5,680	6,201
Term bonds series 1993-A with interest at 5.6%, payable semiannually, due July 1, 2013.....	7,100	7,100

CITY OF BALTIMORE
Waste Water Utility Fund
Notes to the Financial Statements

	<u>2003</u>	<u>2002</u>
Term bonds series 1993-A with interest at 5.65%, payable semiannually, due July 1, 2020	14,000	14,000
Term bonds series 1994-A with interest at 6.00%, payable semiannually, due July 1, 2015.....	4,330	4,330
Term bonds series 1994-A with interest at 5.00%, payable semiannually, due July 1, 2022	7,115	7,115
Term bonds series 2002-A with interest at 5.00%, payable semiannually, due July 1, 2023.....	2,470	2,470
Term bonds series 2002-A with interest at 5.00%, payable semiannually, due July 1, 2027.....	6,070	6,070
Term bonds series 2002-A with interest at 5.20%, payable semiannually, due July 1, 2032.....	9,480	9,480
Term bonds series 2002-A with interest at 5.125%, payable semiannually, due July 1, 2042.....	31,630	31,630
Auction rate notes series 2002-B, payable monthly, due July 1, 2032	25,300	25,300
Auction rate notes series 2002-C, payable monthly, due July 1, 2032	48,300	48,300
Term bonds series 2003-A with interest at 5.00%, payable semiannually, due July 1, 2028.....	6,875	-
Term bonds series 2003-A with interest at 5.00%, payable semiannually, due July 1, 2033	<u>13,950</u>	<u>-</u>
	261,124	236,498
Less unamortized charges.....	<u>2,513</u>	<u>2,821</u>
	<u>\$258,611</u>	<u>\$233,677</u>

The portion of the revenue bonds payable due within one year for the Utility is \$4,660,000.

The term bonds series 1990-B due February 1, 2012, are subject to redemption at par prior to maturity by operation of a mandatory sinking fund in annual principal amounts ranging from \$484,000 to \$730,000. The term bonds series 1993-A, due July 1, 2013, are subject to redemption at par prior to maturity by operation of a mandatory sinking fund on or after July 1, 2009, at annual principal amounts ranging from \$650,000 to \$800,000. The term bonds series 1993-A, due July 1, 2020, are subject to redemption at par prior to maturity by operation of a mandatory sinking fund on or after July 1, 2014, at annual principal amounts ranging from \$850,000 to \$1,150,000. The term bonds series 1994-A, due July 1, 2015, are subject to redemption at par prior to maturity by operation of a mandatory sinking fund on or after July 1, 2010, at annual principal amounts ranging

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from \$620,000 to \$830,000. The term bonds series 1994-A, due July 1, 2022, are subject to redemption at par prior to maturity by operation of a mandatory sinking fund on or after July 1, 2016, at annual principal amounts ranging from \$875,000 to \$1,170,000.

The serial bonds series 1994-A are subject to redemption prior to maturity beginning on and after July 1, 2004, at redemption prices ranging from 102% to 100% of the principal amount.

The Utility serial bonds 2002-A maturing on and after July 1, 2017 are subject to redemption prior to maturity beginning on and after July 1, 2012 at par plus accrued interest thereon. The term bonds series 2002-A due July 1, 2023 are subject to redemption prior to maturity by operation of a sinking fund on or after July 1, 2022 at an annual principal amount equal to \$1,205,000. The term bonds series 2002-A due July 1, 2027 are subject to redemption prior to maturity by operation of a sinking fund on or after July 1, 2024 at annual principal amounts ranging from \$1,405,000 to \$1,480,000. The term bonds series 2002-A due July 1, 2032 are subject to redemption prior to maturity by operation of a sinking fund on or after July 1, 2028 at annual principal amounts ranging from \$1,710,000 to \$1,890,000. The term bonds series 2002-A due July 1, 2042 are subject to redemption prior to maturity by operation of a sinking fund on or after July 1, 2033 at annual principal amounts ranging from \$2,315,000 to \$2,825,000. The term bonds series 2002-B due July 1, 2032 are subject to redemption at par prior to maturity by operation of a mandatory sinking fund on or after July 1, 2015 at annual principal amounts ranging from \$800,000 to \$1,400,000. The term bonds series 2002-C due July 1, 2032 are subject to redemption at par prior to maturity by operation of a mandatory sinking fund on or after July 1, 2003 at annual principal amounts ranging from \$400,000 to \$1,700,000.

The Utility serial bonds 2003-A maturing on or after July 1, 2013 are subject to redemption prior to maturity at par plus accrued interest thereon to the date set for redemption, at the option of the City beginning on and after July 1, 2013 as a whole at the time or in part on any interest payment date, in any order of maturity selected by the City and by lot within any maturity unless the Trustee selects an alternate method it deems proper.

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Principal maturities and interest (amounts expressed in thousands) of revenue bonds are as follows:

Fiscal year ended June 30,			Swap Interest Rate
	<u>Principal</u>	<u>Interest</u>	<u>Net (a)</u>
2004.....	4,660	8,049	3,103
2005.....	4,404	8,445	3,096
2006.....	4,558	8,280	3,096
2007.....	4,729	8,113	3,096
2008	5,397	7,934	3,087
2009 to 2013.....	35,743	36,540	14,802
2014 to 2018.....	40,784	30,557	12,635
2019 to 2023.....	38,544	24,192	10,011
2024 to 2028.....	38,740	18,741	6,680
2029 to 2033.....	48,865	12,553	2,444
2034 to 2038.....	15,880	6,606	
2039 to 2043.....	18,820	2,739	
	<u>\$261,124</u>	<u>\$172,749</u>	<u>\$62,050</u>

(a) Swap Interest Rate Net payments represent estimated payments for additional interest resulting from swap agreements to counterparties. The additional payments were computed using interest rates as of June 30, 2003, assuming current interest rates remain the same for their term. As rates vary, variable rate bond interest payments and net swap payments will vary.

In prior years, the City also defeased revenue bonds by placing the proceeds of new debt issues in an irrevocable trust to provide for all future debt service payments on the old debt. Accordingly, the trust's assets and the liability for the defeased debt are not included in the Utility's financial statements. At June 30, 2003, \$14,620,000 of debt outstanding is considered defeased.

The Utility has various revenue bond covenants that generally require the Utility to maintain rates sufficient to meet the operating requirements of the Utility and an operating reserve as defined in the revenue bond indentures. As of June 30, 2003, the rate requirements were met, and management believes the Utility is in compliance with all significant requirements of the indentures.

8. Interest Rate Swaps

Objectives of the swaps. In order to protect the City against fluctuations in interest rates, the City has entered into 17 interest rate swap agreements. The City's asset/liability strategy is to have a mixture of fixed and variable rate debt to take advantage of anticipated fluctuations in future interest rates, and also to provide the City with low synthetically created rates while providing reasonably predictable future debt service requirements.

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Terms, fair value and credit risk. The terms, fair value and credit rating of the outstanding swaps as of June 30, 2003, were as follows. The notional amounts of the swaps match the principal amount of the associated debt. The City's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow the scheduled or anticipated reductions in the associated "bonds payable" category.

Outstanding Bonds	Effective Date	Termination Date	Interest Rate Paid by City	Interest Rate Received (a, b)	Notional Amount	Fair Value	Counterparty Credit Rating
<i>Fixed to Floating SWAPs</i>							
1993 Revenue Bonds	1/1/2008	7/1/2020	BMA Index	5.54%	\$ 2,507,350	\$ (130,587)	AA+/Aa2
1994 Revenue Bonds	1/1/2008	7/1/2024	BMA Index	5.26%	1,229,550	(91,742)	AA+/Aa2
1998 Revenue Bonds	2/1/2001	7/1/2027	BMA Index	5.17%	25,540,000	2,578,165	AA+/Aa2
1998 Revenue Bonds	7/1/2008	7/1/2028	BMA Index	5.08%	1,876,278	(169,281)	AA+/Aa2
2000 Revenue Bonds	7/1/2003	7/1/2030	BMA Index	5.70%	1,855,869	(123,709)	AA+/Aa2
<i>Floating to Fixed SWAPs</i>							
1998 Revenue Bonds	10/26/2001	7/1/2008	5.17%	BMA Index	25,540,000	(3,744,958)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2037	4.555%	BMA/67% LIBOR	73,600,000	(11,855,470)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2009	3.87%	BMA Index	1,660,000	(97,350)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2010	4.00%	BMA Index	1,785,000	(117,990)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2011	4.10%	BMA Index	1,820,000	(137,565)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2012	4.20%	BMA Index	1,930,000	(162,474)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2013	4.30%	BMA Index	1,960,000	(177,561)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2014	4.39%	BMA Index	2,040,000	(202,507)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2015	4.50%	BMA Index	1,240,000	(131,071)	AA-/Aa3
2002 Revenue Bonds	5/7/2002	7/1/2016	4.61%	BMA Index	1,280,000	(141,036)	AA-/Aa3
2004 Revenue Bonds	6/1/2004	7/1/2034	5.21%	BMA Index	17,500,000	(2,711,921)	AA-/Aa3
2005 Revenue Bonds	6/1/2005	7/1/2035	5.30%	BMA Index	<u>32,600,000</u>	<u>(4,916,491)</u>	AA-/Aa3
Total Outstanding SWAPs					<u>\$195,964,047</u>	<u>\$(22,333,548)</u>	

(a) BMA: Bond Market Association Municipal Swap Index

(b) LIBOR: London Interbank Offered Rate

Fair value. Because interest rates have declined, only one swap had a positive fair value as of June 30, 2003. For the variable rate swap agreements, the fair value of the agreements was \$2,062,846 calculated using the par-value method: the fixed rate on the swap was compared with the current fixed rates that could be achieved in the marketplace should the swap be unwound. The fixed rate bond component was valued by discounting the fixed rate cash flows using the current yield to maturity of a comparable bond. The variable rate component was assumed to be at par value because the rate resets to market rate at every reset date. The fair value was then calculated by subtracting the established market value of the fixed component from the established value of the variable component. For the fixed rate swap agreements, the fair value was (\$24,396,394). The fair values were estimated using the zero-coupon method. This method calculates the net future settlement payments required by the swap, assuming that the current forward rates

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implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swaps.

Credit risk. As of June 30, 2003, the City is exposed to credit risk on only one outstanding swap because all of the other swaps have negative fair values. However, should the interest rates change and the fair values of the swaps become positive, the City would be exposed to credit risk in the amount of the derivatives' fair value. For the one swap agreement that has positive fair value, the City has credit exposure to the counterparty as of June 30, 2003. Should the counterparty to this transaction fail to perform according to the terms of the swap contract, the City faces a maximum loss equivalent to the swap's \$2,578,165 fair value.

The swap agreements contain varying collateral agreements with counterparties. In general, these agreements require full collateralization of the fair value of the swap should the counterparty's credit rating fall below Baa as issued by Moody's or BBB as issued by Standard and Poors. Collateral on all swaps is to be in the form of U.S. government securities held by the City.

Although the City executes transactions with various counterparties, 12 swaps, approximating 83% of the notional amount of swaps outstanding, are held with one counterparty. That counterparty is rated AA-/Aa3. The City holds the remaining five swaps, approximating 17% of the outstanding notional value, with another counterparty, rated AA+/Aa2.

Basis risk. The City's variable rate bond coupon payments are based on weekly market rate, which closely approximates the BMA rate. For those swaps for which the City receives variable rate payment other than the weekly market rate, the City is exposed to basis risk should the spread between the BMA and weekly market rate change. If a change occurs that results in the spread widening, the expected cost savings may not be realized. As of June 30, 2003, the BMA rate was 0.98%, whereas the City market rate ranges from 0.90% to 0.95%.

Interest rate risk. For those swaps for which the City receives fixed rate payments, the City is exposed to interest rate risk. As the BMA/LIBOR (London Interbank Offered Rate) rate changes, expected savings could increase or decrease depending on the relationship between the fixed payments and the variable rate.

Termination risk. The City or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If at the time of termination the swap contract has a negative fair value, the City would be liable to the counterparty for that payment. During fiscal year 2003, the City terminated swap agreements in the Waste Water Utility Fund resulting in losses of \$6,087,000.

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9. Retirement Plan

Classified employees of the Utility are required to join the City of Baltimore's Employees' Retirement System (ERS). The ERS is a multiple-employer cost sharing defined benefit pension plan administered by the City of Baltimore Retirement System. The ERS provides retirement, disability, and death benefits to plan members and beneficiaries. The plan is managed by a Board of Trustees in accordance with Article 22 of the Baltimore City Code. Plan provisions may be amended only by the City Council. The Utility's share of contributions to the plan were \$1,663,000 in 2003, \$1,879,000 in 2002, and \$1,268,000 in 2001. The Utility contributed 100% of the required contribution each of the three years. The ERS issues a publicly available financial report that may be obtained by writing to the City of Baltimore Retirement Systems, Room 640 City Hall, 100 N. Holliday Street, Baltimore, MD 21202.

10. Postemployment Benefits

City administrative policy provides that postemployment benefits, other than pension benefits, be provided to all employees of the Utility. These benefits include certain health care and life insurance benefits. All employees who retire are eligible to receive these benefits. Such benefits are accounted for on a cash basis so that payments during the current year represent benefit coverage for currently retired employees or their beneficiaries. During fiscal years 2003 and 2002, the Utility's share of the City's postemployment benefit payments were \$3,174,000 and \$2,965,000, respectively.

11. Risk Management

The Utility participates in the City's risk management program. The City is exposed to various risks of loss related to torts; theft of, damage to, and destruction of assets; errors and omissions; injuries to employees; and natural disasters. During fiscal year 1987, the City established the Risk Management Fund (an internal service fund) to account for and finance its uninsured risks. The City's risk financing techniques include a combination of risk retention through self-insurance and risk transfer through the purchase of commercial insurance. The Risk Management Fund services all claims for risk of loss, including general liability, property and casualty, workers' compensation, unemployment compensation, automobile physical damage and bodily injury and sundry other risks. Commercial insurance coverage is provided for each property damage claim in excess of \$750,000 with a cap of \$250,000,000. Settled claims have not exceeded this commercial coverage in any of the past three years. The City also provides medical insurance coverage for all employees and retirees. Employees are required to pay a percentage of the annual costs of medical plans, and the remaining costs are paid by the City's internal service fund.

All funds of the City participate in the program and make payments to the Risk Management Fund based on actuarial estimates and historical cost information of the amounts needed to pay prior and current year claims. During fiscal years 2003 and 2002, the Utility's share of the City's cost was \$6,949,000 and \$6,091,000, respectively.

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12. Commitments and Contingencies

The Utility has received Federal grants in the amount of \$20,000 and \$668,000 for 2003 and 2002 and State grants of \$1,556,000 and \$23,000 for 2003 and 2002, respectively. Entitlement to grant resources is generally conditioned upon compliance with terms and conditions of the grant agreements and applicable Federal and State regulations, including the expenditure of the resources for eligible purposes. Substantially all grants are subject to financial and compliance audits in accordance with grantors' requirements. Any disallowances as a result of these audits become a liability of the Utility. As of June 30, 2003, the Utility estimates that no material liabilities will result from such audits.

The Utility has entered into a 20-year Sewerage Sludge Disposal Agreement with the Northeast Maryland Waste Disposal Authority in connection with the financing of a sludge composting facility in Baltimore City. The agreement obligates the Utility to deliver approximately 55,000 tons of sewerage sludge per year and to pay a tipping fee comparable to alternative methods currently being used by the Utility. The debt service on variable rate bonds is a component of the tipping fee. The Utility's current tipping fee expense for delivering sewerage sludge is approximately \$105.36 per wet ton. Payments under the agreement in fiscal year 2003 were \$4,671,000.

The Utility has also entered into 20-year Service Agreements with Wheelabrator Water Technologies Baltimore L.L.C. in connection with the financing of heat drying facilities for processing biosolids at the City's Back River and Patapsco Waste Water Treatment Plants. The agreements obligate the Utility to deliver approximately 20,000 dry tons of biosolids per year at each facility and to pay a tipping fee. The debt service on the bonds is a component of the tipping fee. The Utility's current tipping fee expense for delivering biosolids is approximately \$526.80 per dry ton. Payments under the agreement in fiscal year 2003 were \$15,798,000.

The City of Baltimore has voluntarily entered into a Consent Decree to rehabilitate its aging sewer infrastructure and correct historical overflow mechanisms. The Consent Decree is one of many the U.S. Department of Justice is and has currently negotiated with major east coast cities with aged sewer and storm water infrastructures. The City is proactively negotiating to ramp up its remedial efforts to address discharge and overflow concerns of the State and Federal regulatory agencies. These efforts are ambitious and the cost of the construction and maintenance are estimated to range between \$500 to \$700 million dollars over the next decade and beyond. The City has committed to financing these remedial efforts through a combination of water and waste water revenue bonds in conjunction with all available State and Federal assistance.

13. Subsequent Events

On October 1, 2003, the City of Baltimore issued \$2,030,810 of Waste Water Quality Bonds Series 2003-B, maturing through the year ending 2033.